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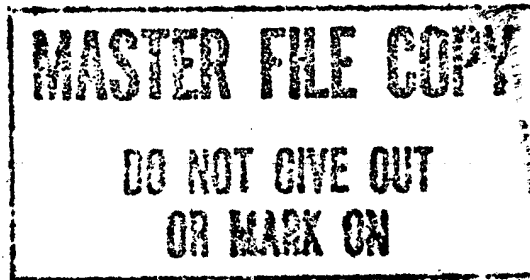
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Brazil's Sarney Administration: Economic Stabilization and Democracy

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An Intelligence Assessment

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June 1986

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Brazil's Sarney Administration: Economic Stabilization and Democracy

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An Intelligence Assessment

This paper was prepared by [redacted]
[redacted], Office of African and Latin American
Analysis, [redacted]

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Comments and queries are welcome and may be
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**Brazil's Sarney Administration:
Economic Stabilization
and Democracy**

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Key Judgments

*Information available
as of 28 April 1986
was used in this report.*

Brazil's relatively smooth transition to civilian rule under the year-old administration of President Jose Sarney has served broad US interests in furthering the democratization process in Latin America and in maintaining the stability of the region's most populous and economically powerful state. Thrust unexpectedly into the presidency after the death in April 1985 of President-elect Tancredo Neves and lacking Neves's stature and national political base, President Sarney has, nevertheless, succeeded so far in holding together a disparate governing coalition, maintaining military backing, and pursuing economic policies that last year helped Brazil register the world's highest GNP growth rate.

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With his political base strengthened by the results of last November's municipal elections, an increasingly self-confident Sarney has recently abandoned his low-key style and begun to use more freely the considerable authority of the Brazilian presidency to gain control over an inflation rate that had soared to an annualized monthly rate of more than 400 percent. He made his boldest move in February by announcing an unprecedented economic program that includes currency reform, a temporary wage and price freeze, and gradual elimination of Brazil's pervasive indexation system.

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To date, the emergency program has enjoyed strong popular support and has succeeded in squeezing monthly inflation to near zero. We believe the Sarney administration will maintain rigorous controls over prices for most or all of this year and, consequently, probably will depress average inflation for 1986 to about 75 percent. In our view, the program also will slow economic growth this year 4 to 5 percent by restraining wages and discouraging new private investment.

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Brazil is likely to improve its ability to service its \$100 billion foreign debt by registering another \$12-13 billion trade surplus this year, in part because of surging coffee revenues and sharply falling oil expenditures. Also, a recent restructuring of 1985 and 1986 bank debt coupled with declining interest rates will reduce debt servicing costs substantially.

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We believe economic achievements of this order will allow Sarney to retain the support of the centrist political majority and the military while keeping the left off balance, particularly Leonel Brizola, the Governor of Rio de Janeiro and a presidential aspirant. As a consequence, we expect Sarney to

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emerge strengthened from the key gubernatorial and congressional elections this fall and to play a crucial role in the drafting of a new constitution in 1987 that is to reshape Brazil's political system.

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Sarney's political fortunes, however, will remain hostage to the health of the economy, which could still weaken as the result of any one of several factors. Governmental fiscal vacillation in the face of interest group pressures, for example, could lead to continued expansion of the public deficit and the monetary aggregates, not only rendering impotent the emergency program but triggering resurgent inflation. Under deteriorating economic conditions, leftist groups probably would stir social discontent, make considerable gains in the congressional elections, and prompt a reaction from Brazilian conservatives that eventually would lead to a highly polarized environment. On balance, however, we believe that such a souring of events will not occur and that Sarney will continue to preside over a fairly smooth transition process.

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We expect a politically and economically secure Sarney administration to strive to maintain reasonably harmonious relations with the United States, although some frictions will undoubtedly continue even under the best of circumstances over trade, foreign investment, and debt policies. For the most part, his administration should continue to be moderately sympathetic—though not acquiescent—to US concerns on arms sales to pariah states such as Libya, narcotics control, and blunting Cuban and Soviet adventurism in South America. If the economy unexpectedly weakened and Sarney's political position deteriorated, however, he might take policy positions inimical to US interests, becoming more confrontational on debt policy—particularly if there was a concomitant rise in US interest rates or a spate of protectionist legislation—and less cooperative with US foreign policy initiatives.

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Contents

	<i>Page</i>
Key Judgments	iii
Introduction	1
Sarney Strengthens Political Standing	1
Emerging From Neves's Shadow	1
A Return to Rapid Economic Growth	3
An Electoral Windfall	5
Storm Clouds Brew	5
Inflation Surges	5
Political Consequences	6
Sarney's Response	6
Increased Political Assertiveness	6
Economic Shock Treatment	7
Near-Term Challenges	7
Avoiding Pitfalls in the Economic Plan	7
Keeping the Left in the Wings	8
Cultivating the Military	9
Outlook	9
The Downside Risk	11
Implications for the United States	12

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Figure 1



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Brazil's Sarney Administration: Economic Stabilization and Democracy

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Introduction

The untimely death of the immensely popular President-elect Tancredo Neves presented both problems and opportunities for his successor, Jose Sarney. While Neves's demise initially created considerable anxiety within both civilian and military circles, it dampened popular expectations and probably gave Sarney greater maneuverability and a longer "honeymoon" than Neves would have had. By increasingly assertive use of his presidential authority and adroit political maneuvering, Sarney was able to keep the transition on track and begin constructing a popular base for his government.

In our view, Sarney, however, faces greater challenges in his second year in office than in the first. Gubernatorial and congressional elections in November will test the strength of the governing coalition parties. Sarney's ability to implement successfully his recently announced economic stabilization package in the face of interest group resistance and to balance competing political elements will be a key factor in ensuring the election of moderates. The political atmosphere will heat up even more as the new congress—also empowered to act as a constituent assembly—begins drafting the new constitution in early 1987. Apart from the overall task of reshaping the political system, the assembly also will be responsible for setting the date for Brazil's first direct presidential election.¹

This paper provides our first comprehensive assessment of the prospects for Brazil's civilian government over the next year. It is the first of several papers designed to follow the complex political and economic developments in the redemocratization of Latin

¹ According to the present constitution promulgated under the military regime, Sarney is to serve a six-year term. During the presidential campaign in 1984, however, the late Tancredo Neves and Sarney stated their preference for a four-year term. Sarney publicly has reiterated this stance but stated that, ultimately, the constituent assembly will decide the length of his tenure.

America's largest country.

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Sarney Strengthens Political Standing

Emerging From Neves's Shadow

Sarney faced an uphill struggle for public and political acceptance when he assumed the presidency on 21 April 1985. According to the US Embassy, the leaders of the Brazilian Democratic Movement Party (PMDB) had accepted Sarney as the vice-presidential candidate at Neves's behest, but distrusted Sarney because of his former membership in the old military government party, the Democratic Social Party (PDS). Moreover, the military and the PDS disliked him for having left their party to help form the Liberal Front Party (PFL) and joining Neves's Democratic Alliance. Finally, Sarney was a politician whose experience and backing was confined primarily to the "backward" northeast, and he lacked Neves's national prestige, recognition, and popularity.

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Upon taking office, Sarney immediately moved to bolster his political backing. He invoked Tancredo's memory to appeal for the support of the governing Democratic Alliance in order to present the image of a unified civilian government. US Embassy reports indicate Sarney also continued Neves's practice of consulting with politicians ranging from the left of center to conservatives to prevent infighting and damage to the image of civilian leaders in the weeks following the President-elect's death.

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Throughout 1985 Sarney moved purposely to retain military backing.

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He withstood pressure from some radical leftist groups to hold widespread investigations into human rights abuses under the military regime, made

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Brazil's Major Political Parties**The Governing Coalition**

The Brazilian Democratic Movement Party (PMDB), the majority partner in the governing coalition, is the country's largest party, claiming 2.2 million members nationwide. Formed in 1981 from the conservative Popular Party and the Brazilian Democratic Movement—the official opposition party to the military government—the PMDB's heterogeneous membership runs the ideological gamut from conservative to Marxist. The PMDB's 217 delegates in the lower house of Congress—out of total membership of 479—include approximately 60 leftists who have pushed Ulysses Guimaraes, president of the Chamber and leader of the party, to distance the party from President Sarney. []

The Liberal Front (PFL)—the minority party in the coalition—is more homogeneous, center right with a base of support in Brazil's northeast. The PFL was founded in 1984 by Sarney and a number of prominent defectors from the military-backed Social Democratic Party (PDS) who left to join Tancredo Neves's Democratic Alliance. US Embassy reporting indicates the PFL has a number of prominent likely presidential aspirants, but a weak grassroots membership. []

Other Center-Right Parties

Social Democratic Party (PDS)—Although it still controls some 95 seats in the Chamber of Deputies, the party is largely discredited because of its role in the military government and may disappear as its most prominent members defect to other parties. []

Brazilian Labor Party (PTB)—Founded in 1945 by the late President Getulio Vargas, the PTB has waxed and waned as a political force since his death in 1954. His daughter revived the party in 1980 and led it until her death in 1984. Until this May when he quit the party, Janio Quadros used the PTB as his personal political vehicle, winning the Sao Paulo mayoralty in November 1985. Although still small in numbers, it has an active, large youth wing and has

recently attracted a number of prominent conservative businessmen, academics, and politicians who advocate frugality and honesty in government as well as an IMF-oriented economic policy. []

Leftist Parties

The Democratic Labor Party (PDT), as illustrated by the results of the November 1985 municipal elections, is expanding its influence outside of its political base in Rio. Founded in 1980 and controlled by Rio de Janeiro state Governor Leonel Brizola, the PDT is the second-largest party in numbers of elected officeholders nationwide and the fourth largest in Congress. Although in the past the party has reflected Brizola's militant leftist views, US Embassy and press reports indicate the Governor is beginning to remold the PDT's image along the lines of a center-left, West European social democratic party, which he hopes will win the support of moderates for his presidential campaign. []

The Workers Party (PT) was founded in 1980 with the backing of unions in the industrial city of Sao Paulo. An umbrella group of Marxist parties headed by the charismatic labor leader, Lula da Silva, the PT has increased its membership significantly in the past year. The PT, which claims 320,000 supporters nationwide, supports labor militancy to improve worker living standards and has called numerous strikes through its labor arm, the CUT. Although a number of the PT's component groups are dyed-in-the-wool Marxists, the party is taking a moderate, pragmatic approach publicly. []

Brazil's Communist parties are small, but active and ideologically coherent. The largest is the Brazilian Communist Party (PCB), which follows Moscow's line and claims to have increased its membership from 6,000 to 27,000 since Sarney took office, []

While some members of the PCB advocate violence, the leaders have decided that the party will continue to work peacefully and through democratic channels. The Communist Party of Brazil (PC do B) has some 5,000 to 8,000 members, and is more militant, espousing violent strikes and land seizures. []

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high-profile appearances at military ceremonies [redacted]

Although Neves had promised to cooperate with Brazil's foreign creditors, the Sarney government sought to bolster its popular standing by taking a much tougher stand in its relations with the IMF and the banks. According to 1985 polls, most educated Brazilians believed the implementation of IMF prescriptions would prevent expected living standard improvements. US Embassy sources reported Sarney feared that acceding to IMF requirements for prompt and deep cuts in public spending would produce a recession and a political backlash. Accordingly, Brasilia announced in late 1985 that it would no longer seek a formal agreement with the Fund, and would proceed with its own more gradual economic adjustment program tailored to domestic political realities. [redacted]

Sarney also sought to capitalize on the wave of public support for political change by moving rapidly to implement the political liberalization measures promised by Neves. By May he had pushed through Congress bills providing for direct presidential elections and a constitutional assembly, legalizing the banned leftist political parties, and authorizing democratic municipal elections. The US Embassy reports that the administration also granted labor more autonomy in negotiating with employers and began integrating the Congress more effectively into the policymaking process by consulting frequently with key congressional leaders on important legislation. Largely because of these steps, Sarney's public approval ratings in opinion polls exceeded 60 percent during much of the year, according to the US Embassy. [redacted]

A Return to Rapid Economic Growth

By far the most important element in Sarney's strategy to establish his presidential standing was the high priority he assigned to economic policies aimed at restoring rapid growth and redressing long-neglected socioeconomic inequities—the so-called social debt—both highly popular goals in Brazil. To stimulate

domestic demand, the administration permitted large real wage increases and substantially increased public spending, particularly on health, education, food, and housing. Furthermore, the government maintained rapid monetary growth in an attempt to lower domestic interest rates. According to the US Embassy, industrial employment grew some 5 percent in 1985 while the gross domestic product rose more than 8 percent—the highest rate in the world last year [redacted]

The administration's decision to soft-pedal stabilization in deference to politically popular rapid growth did nothing to curb the triple-digit inflation rate—prices rose 234 percent last year compared to 225 percent in 1984. Brazilian economists report that the surge would have been considerably higher had it not been for use of price controls and other artificial restraints. As the public-sector deficit soared to a record high following two successive years of sharp decline, institutional reforms languished. Sarney made little progress in trimming the overgrown and inefficient state-owned corporations, he chose not to tamper with the politically sensitive indexation system—whereby wages, rents, and the value of government securities and other instruments have been periodically adjusted to compensate for past inflation—and he deferred plans to complete a much-needed budget reform. [redacted]

Despite these stimulative policies, Brasilia maintained a strong foreign payments position, mainly because of its successful import-substitution program. Official statistics show a second successive annual trade surplus exceeding \$12 billion last year. Although the government continued its aggressive currency devaluation policy, exports fell some 5 percent to \$25.6 billion because of lower commodity prices and slowed growth in the OECD. An exhaustive US Embassy analysis indicates, however, that the moderate drop in foreign sales was largely offset by a \$1.1 billion cut in oil imports as domestic crude production jumped 20 percent to 563,000 barrels per day average during 1985.² The resulting large trade surplus and falling

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The Municipal Elections: Old and New Politics

The municipal elections in November 1985—the first elections under civilian rule—presented outside observers with a kaleidoscopic view of the transitional nature of politics in Brazil. Old and new political styles, symbols, figures, parties, and ideologies intermingled in a complex manner that mirrored the country's socioeconomic development—rapidly modernizing, yet tradition bound in many respects. [redacted]

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The governing coalition, the Democratic Alliance, turned in a mixed performance in the campaigns. The senior partner, the Brazilian Democratic Movement Party (PMDB), won a majority of the municipalities—116 out of 160—but lost in Rio de Janeiro, Porto Alegre, and Sao Paulo. The defeat in Sao Paulo of the PMDB standard bearer, Fernando Henrique Cardoso, effectively dashed the prospects of the party's principal presidential hopeful, opening the field to a host of other key party figures. The setback led to a renewal of bitter infighting of the sort that has frequently threatened to split the party. The coalition's minority partner, the Liberal Front Party (PFL), performed poorly, failing to capture even a single mayoralty. [redacted]

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The two principal leftist parties, the Democratic Workers Party (PDT) and the Workers Party (PT), fared well in the elections. Led by the leftist Governor of Rio de Janeiro, Leonel Brizola, the PDT succeeded in expanding its base outside Rio by winning the important city of Porto Alegre and even some northeastern cities. The PT was able to move out of its home base of Sao Paulo, winning several rural municipalities nearby and even capturing the important northeastern city of Fortaleza. [redacted]

Press reports about the local campaigning highlighted the persistence of traditional personalistic politics. Politicians continued to improve their prospects of winning office by becoming the proteges of more powerful individuals, best illustrated by the electoral assistance provided by Brizola to candidates outside Rio state. In Sao Paulo, a coalition of disparate interest groups tied themselves to the old style, and often demagogic, populist politician Janio Quadros. In the northeast, moreover, prominent individuals and families frequently outweighed parties in delivering votes. [redacted]

At the same time, political commentators were cheered by signs during the elections that Brazil is developing a modern political party system. At present, Brazil has over 30 legalized parties, although many are likely to disappear. Nevertheless, the largest parties are thriving and have begun to utilize modern electioneering techniques, including polling, sophisticated media campaigns, and use of US political consulting firms to campaign for office. For the first time, many parties hammered out coherent, pragmatic platforms to win voters. [redacted]

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In the November municipal elections, according to press and Embassy reporting, the electorate focused on a range of issues that the new civilian politicians will have to act on to retain popular support. Press and Embassy reporting indicate that voters signaled their impatience with government redtape, corruption, and inefficiency by rejecting incumbents in many cities. In our view, the prominent emphasis given to such issues as social reform and honest government augur additional changes in Brazil's patrimonial political system. [redacted]

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interest rates permitted Brasilia to cover its interest payments on foreign debt, to refrain from seeking new money from commercial banks, and to hold its international reserves at more than \$11 billion. []

An Electoral Windfall

In the November 1985 elections, the first nationwide test at the polls since he took office, Sarney chose to place the continuing consolidation of his own position above partisan interests. With offices in 160 municipalities up for grabs, the President opted not to campaign for the parties in his coalition, but instead to stand above the contest and identify himself with the election as another democratic advance. Sarney reasoned, in our judgment, that this approach would ensure that he would not personally suffer from any party losses, but would profit from the elections having taken place, regardless of outcome. []

Not only did this strategy prove correct, but the President also benefited from the mixed electoral performance of the PMDB. US Embassy and press reports indicate that, until the election, Sarney had been facing increasing difficulties with the PMDB congressional bloc—the largest in Congress. Led by the dominant Sao Paulo faction, PMDB congressmen not only had balked at backing the administration's legislation, but on some occasions had openly obstructed the President's legislative initiatives. The Embassy and political commentators indicated, however, that the defeat of the PMDB mayoral candidate on its home turf in Sao Paulo by the populist ex-President Janio Quadros, represented a setback for the party's dominant faction. []

the poor electoral showing by the old military government party also led many of its members to switch to the PFL and the PMDB, thus bolstering the centrist and conservative elements in the governing coalition. []

Storm Clouds Brew

Inflation Surges

At the beginning of 1986, Sarney's political strategy appeared to us to be succeeding on all fronts except one: inflationary pressures that had accumulated over the months of expansionary policies had begun to swell out of control and evoke strong public concern. Monthly inflation accelerated to a more than 400-percent annual rate between November 1985 and February of this year as expanding domestic demand, drought-induced food shortages, and diminishing excess industrial capacity overwhelmed the government's patchwork inflation-fighting measures. [] [] increasingly serious price distortions in the economy and faltering public confidence in Sarney. []

Growing pessimism about inflation and a tightening financial squeeze caused many domestic and foreign private-sector firms in Brazil to defer plans for investment despite near-capacity utilization rates, according to the US Embassy. The weakened financial position of the private sector reportedly stemmed from high interest rates, rising labor costs, price controls, and increased corporate taxation. The Embassy also noted that, for the first time since 1971, remittances of profits and dividends by multinational corporations in Brazil exceeded new foreign direct investment flows, further intensifying the investment squeeze. []

Brazil also encountered difficulty obtaining a multiyear rescheduling agreement from its foreign creditors. Although Brazil's bank advisory committee tentatively agreed last January to reschedule debt due in 1985, to roll over 1986 principal, and to maintain short-term credit lines without a formal IMF agreement, it sought additional policy assurances from the government before finalizing the accord. The banks wanted the government both to guarantee repayment of foreign obligations owed by three failed private Brazilian banks and to make stronger adjustments to quell growing inflationary pressures. []

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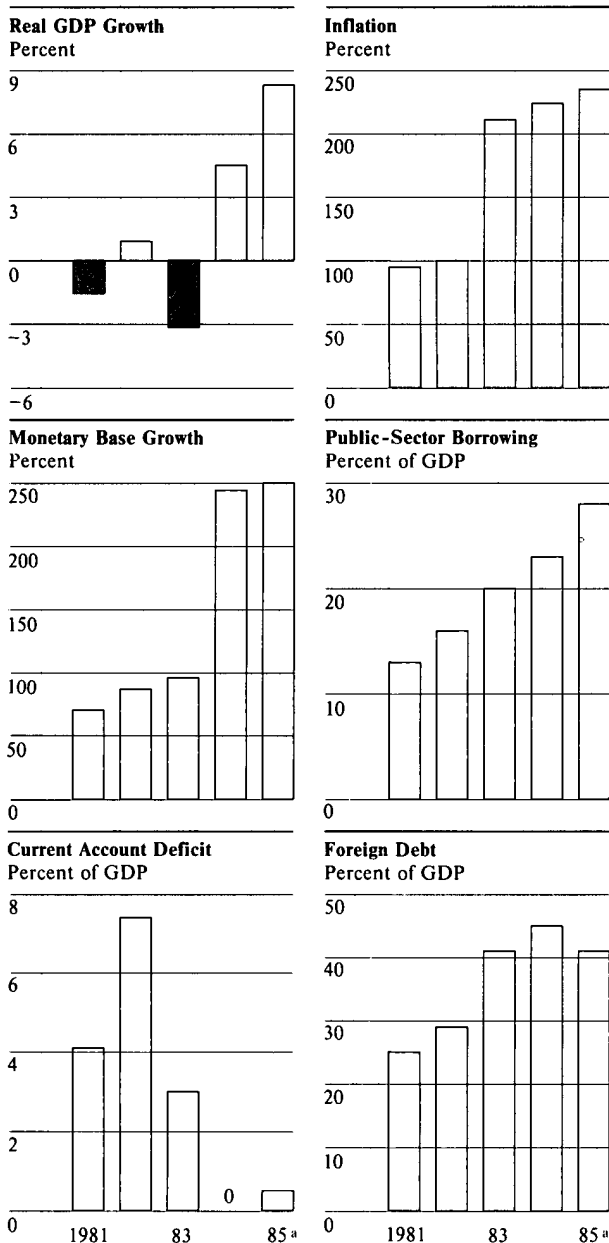
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Figure 2
Brazil: Economic Indicators,
1981-85

^a Estimated.

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Political Consequences

The US Embassy reported that rising inflation—particularly the announcement of a record monthly price increase in January of this year—sent shockwaves through the country. President Sarney came under increasing political pressure from the diverse elements in the governing coalition to take action. The left wing of the PMDB stepped up its attacks on Sarney's economic policies, accusing the President of not doing enough to bring about economic and social change, according to the US Embassy. While not as sharply critical of Sarney, the moderate politicians in the PMDB and the PFL became increasingly concerned about the damage accelerating inflation could have on their prospects in the congressional and gubernatorial elections scheduled for November 1986.

The leftist opposition and labor also moved to exploit the political opportunity.

Brazilian labor served notice that it would take a more militant stance when, in January, the most aggressive labor confederation, the Unified Workers Central (CUT), announced its intention to launch a series of strikes pushing for increased salaries and benefits.

Sarney's Response

Increased Political Assertiveness

Sarney's response to these challenges was a dramatic shift in both style and policy. Feeling less beholden to the governing coalition, Sarney abandoned his

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low-key governing style and began in early 1986 to exercise more freely the considerable authority of the Brazilian presidency, using federal troops to stop a disruptive truckers' strike in January, for example. More important, he reshaped the Cabinet to make it more politically conservative and personally loyal, and reorganized the presidential staff to make it more effective, especially in dealing with Congress. Working primarily behind the scenes, he adeptly soothed the bruised egos of PMDB leaders who were angry at his Cabinet shifts and headed off their defection from his government. []

Economic Shock Treatment

On the economic policy front, Sarney declared war on inflation; the opening round was signaled by the administration's announcement at the end of January of a major reform of the federal budget process and the conduct of monetary policy. A major effect of the reform was to eliminate the longstanding open line of credit, known as the *conta de movimento*, that the central bank had made available to the Bank of Brazil—a large government-owned commercial bank—to finance the government's various commodity and credit subsidy programs. Under the reform, control over such Bank of Brazil expenditures has shifted to the Treasury, whose budget is required by law to be in surplus or balance. The reform strengthened considerably the ability of the Finance Minister—who oversees Treasury affairs—to control the execution of the federal budget process and limit increases in the money supply. []

Sarney launched his main attack on inflation on 28 February when he announced the implementation of a bold new emergency program, dubbed the Tropical Plan, which he asserted would eliminate inflation without precipitating another recession. According to the decree law, the program gradually ends the pervasive indexation system that has been the major impediment to conventional efforts to reduce inflation for more than 20 years. With indexation abolished, the administration also hopes to encourage investors to shift their resources from financial speculation to economically productive enterprises. The program also features a new "cruzado" currency, a fixed cruzado-dollar exchange rate, and a temporary—but

comprehensive—wage and price freeze. To appease labor, Brasilia promised a wage adjustment when increases in costs of living reach 20 percent, and established a new unemployment insurance scheme. []

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At the outset, the Tropical Plan stopped inflation in its tracks, at least temporarily—inflation was squeezed to near zero in both March and April—and the plan gained widespread popular backing. Furthermore, by this action, President Sarney has established his political control, addressed the economic concerns of the PMDB, and, for the present at least, undercut his leftist critics. []

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Near-Term Challenges

Sarney's assertive approach to dealing with Brazil's economic difficulties and party politics has done much to dispel the image of insecurity and indecisiveness he projected during his initial months in office. Developments in several key areas, however, will test both Sarney's ability to build on his recent success and his mettle as a national leader over the long haul. []

Avoiding Pitfalls in the Economic Plan

Hewing to the Tropical Plan in the face of slowing economic growth will test Sarney's political nerves. The US Embassy notes that domestic demand is subsiding as a result of defused inflationary expectations and languishing wages. Meanwhile, continuing uncertainty in the business community—especially regarding the duration of the price freeze—is discouraging new private investment at a time when capital expansion will be necessary to sustain industrial growth. Nor do we believe that the public sector is likely to find itself in a strong enough financial position to pick up the slack. Furthermore, the domestic banking sector has seen its profits nosedive as a result of deindexation and may be in a weakened position to finance Brazil's industrial recovery. With economic growth already racked by the effects of the drought in the south on agriculture, various components of the economic plan threaten to slow growth significantly. []

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The Government's Massive Domestic Debt

The US Embassy reported that Brasilia's public-sector deficit and borrowing requirements last year exceeded 25 percent of GDP for the first time. Domestic capital markets were required to fund the deficit since the government chose to forego new foreign commercial bank loans. By the end of the year, official statistics indicate the government's domestic debt reached more than \$30 billion and, in the view of growing numbers of Brazilian economists, is now as serious a financial problem as the foreign debt. We concur with their analysis that the size of the domestic debt, the nominal value of which was indexed to inflation, was a major impediment to effective fiscal and monetary management. For example, the continued large public-sector borrowing needed to pay the growing cost of domestic debt servicing—in addition to funding rising military, social, and investment appropriations—had pushed up real interest rates to about 20 percent in Brazil's financial markets, and limited credit available to the private business sector. [redacted]

Under these circumstances, opposition to the program is likely to grow, especially on the part of labor. We believe that by late summer not only the more radical CUT but also the moderate CGT are likely to press the government more vigorously for real wage increases even if the new package has succeeded in slashing inflation. [redacted]

For the stabilization program to quash inflation effectively, in our judgment, Brasilia will have to back up its wage and price freezes and deindexation measures with more vigorous budgetary and monetary adjustments. We believe the administration will need considerable courage to slash the public-sector deficit in the face of pressures from the state corporations and other interest groups in a major election year. For example, the armed services continue to press for sizable hikes in military appropriations, and Electrobras—the state-owned electric power company—wants to augment its spending considerably this year

to expand the electrical transmission grid. Furthermore, we believe Sarney will face pressure from the middle-to-lower income classes to redress social inequities through increased budgetary allocations. President Sarney, for example, approved an agrarian reform plan late last year aimed at redistributing land to 1.4 million families over four years, and he needs to assure adequate financial banking—the government estimates \$6 billion—for the program to avoid stirring rural unrest among these small subsistence farmers.

Keeping the Left in the Wings

The opposition left remains poised to capitalize on any economic and political difficulties that may beset the President during the year. In particular, the left is looking to exploit in the upcoming congressional and gubernatorial elections any drop in Sarney's popularity resulting from the administration's inability to ensure that the emergency program slashes inflation but avoids recession. The leftist groups also hope to take advantage of divisive competition among their centrist and conservative adversaries—such as is occurring in the gubernatorial race in Sao Paulo—to score electoral gains in key areas. For the most part, the leftist parties—ranging from center left to radical Marxist—have avoided violent tactics and are intent on rebuilding their party structures in preparation for the November elections. [redacted]

In our view, Brizola is still Sarney's most formidable opponent on the left. [redacted]

Brizola continues to court leftist-leaning members of the PMDB who are dissatisfied with the growing influence of more conservative elements in the coalition and the Cabinet, according to the US Embassy. [redacted]

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While diminished inflation and continued growth will be his most effective allies in keeping the left in check, the steps Sarney takes on the political and social fronts will also be important. To counter Brizola's efforts to unify the leftist opposition and lure away the left wing of the PMDB, for example, Sarney will have to maintain a moderately nationalistic stance on the debt issue as well as continue to demonstrate his commitment, if only primarily symbolic, to agrarian, judicial, social, and political party reform. Moreover, Sarney will increasingly have to utilize the resources and prestige of his office, particularly in stumping for the congressional and gubernatorial aspirants of the Democratic Alliance, to maintain a strong moderate and conservative base of support.

Cultivating the Military

Even though most senior officers apparently want to concentrate on improving professional skills, the military as an institution still wields considerable political influence and is likely to make its influence felt on issues it regards as vital to its own integrity and to Brazil's stability. The armed forces are the principal proponents of the unsafeguarded nuclear program and are likely to weigh in with President Sarney on key aspects of foreign relations, such as ties to the Soviet Bloc and arms sales to Libya or Iran.

The US Embassy reports that senior officers are fearful that the convention would attempt to alter their traditional right to intervene to protect national security and the constitutional order—a likely result if the assembly were leftist dominated.

We believe Sarney will have to remain sensitive to the military's preoccupations and concerns. While he may attempt to persuade the armed forces to exercise restraint in arms appropriations requests to control the government deficit, for the most part he will have to back increased funding for military force modernization as well as the nuclear program. Moreover, it will be important for him to continue to cultivate close personal relationships with key military officers—especially Army Minister Pires Goncalves—and take their advice on internal security matters and key foreign policy issues. Finally, Sarney will have to lobby actively among politicians of all political stripes to make sure that the constituent assembly does not attempt to alter the constitutional role of the military.

Outlook

Given what we have seen of Sarney to date, we are reasonably confident that he will be able to maintain a stable transition in the period ahead, notwithstanding various economic and political challenges. On the all-important economic front, we believe Sarney probably will cut inflation sharply this year with his stabilization program and reap substantial political gain. We believe Sarney will maintain rigorous price controls for all or most of 1986 because steps to clamp a tight lid on fiscal spending and credit expansion will be politically difficult in this important election year. Despite the sharp acceleration of prices in January and February, we project that the program will cut the annual inflation rate to about 75 percent by the end of the year. We believe this would keep Sarney's popular approval rating high and help secure the acquiescence of labor and business to the wage and price controls. We expect economic growth to slow as a result of the program's wage restraints and continued investor uncertainty under the price control environment. Nevertheless, we believe the momentum of last year's robust recovery should enable Brazil to record a politically acceptable 4-to-5-percent real economic growth rate in 1986.

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Brazil: Balance of Payments

	1983	1984	1985	1986 ^a
Trade balance	6.5	13.1	12.4	12.5
Exports	21.9	27.0	25.6	26.5
Oil	1.4	1.8	1.5	1.6
Nonoil	20.5	25.2	24.1	24.9
Imports	15.4	13.9	13.2	14.0
Oil	-8.2	-6.9	-5.8	-4.3
Nonoil	-7.2	-7.0	-7.4	-9.7
Net services transfers	-13.3	-13.0	-13.6	-12.5
Interest on debt	10.2	10.2	10.4	9.1
Other, net	-3.1	-2.8	-3.2	-3.4
Current account	-6.8	0.1	-1.2	0.0
Capital account	5.5	6.1	1.2	1.0
Long-term inflows, net	6.6	8.3	1.0	0.5
Principal payments	3.4	2.0	2.1	2.5
New borrowing	10.0	10.3	3.1	3.0
Direct investment	1.4	1.6	1.3	1.3
Short-term movements	-2.5	-3.8	-1.1	-0.8
Reserve changes	-1.3	6.2	0.0	1.0

^a Projected.

Also helping Sarney's standing in 1986, in our view, is the likelihood of another large external trade surplus—about \$12.5 billion—that will boost reserves and prevent relations with creditors over the foreign debt from becoming a significant campaign issue. Exports probably will rise to \$26.5 billion as a recent price boom aids coffee earnings and sales of manufactured goods benefit from continued OECD growth and the decline of the US dollar. At the same time, a \$1.5 billion drop in foreign oil purchases—primarily reflecting slumping world petroleum prices—probably will keep overall imports close to \$14 billion, despite expected large acquisitions of foreign grain to offset drought-inflicted crop losses. The resulting trade surplus and the recent agreement to roll over debt to commercial banks until 1987 will enable Brazil to meet easily its scheduled \$9.1 billion in interest payments and to balance its current accounts.

In the absence of serious economic difficulties that would serve as an opposition rallying point, we believe neither the left nor labor will pose a direct threat to Sarney. [redacted] longstanding enmities between labor leader Lula and Brizola are undermining the chances of an alliance between Brazil's two leading leftist parties. Moreover, the two major labor confederations are presently engaged in a bitter struggle for dominance of the labor movement. In this context, labor will probably be unable to mount large-scale strike activity in the face of Sarney's apparent determination to use his considerable legal authority to prevent violent or economically disruptive labor strife or expensive settlements. Finally, the US Embassy reports that opposition in most political circles—even in the Brazilian

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Brazil's Strategy With International Creditors

[redacted] Brazilian officials are emphasizing that it is politically impossible to restructure commercial bank debt on the basis of a formal IMF agreement in 1986. Brasilia may continue to probe creditor governments and banks for new arrangements that could lead to a multiyear debt rescheduling agreement but without preconditions of a formal IMF program. [redacted]

[redacted] the government believes it is in a strong economic bargaining position to obtain such concessions from creditors because of its impressive trade performance, its plans not to seek new loans in 1986, and recent US support for greater flexibility on the debt management. Meanwhile, Brasilia will continue to value its own credit standing with the banks by meeting all interest payments when they come due, and to refrain from participating in any radical regional initiatives directed at creditors. [redacted]

Although Brazil is prepared to "go it alone" in 1986, we do not judge this policy as portending a permanent financial break. Instead, we believe Brazil may be more receptive to an IMF standby, or an enhanced monitoring agreement, after the November 1986 elections, depending on the outcome. The Sarney administration may also feel that if its recently announced emergency stabilization program succeeds by the end of the year in dramatically reducing inflation, the IMF will become willing to exact less onerous conditions from Brazil for a new agreement. In any event, according to the US Embassy, the Sarney government understands that some form of IMF accord will be essential to persuade foreign banks to extend additional new loans. [redacted]

Communist Party (PCB) [redacted]

[redacted]—to a November presidential election will allow Sarney to rebuff efforts by Brizola to shorten his term. [redacted]

We expect Sarney will retain the backing of the military senior command. [redacted]

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Barring the unexpected in the economy or on the political front, we believe Sarney will play a crucial role in the constituent assembly scheduled to begin writing a new constitution in February 1987. Capitalizing on a public perception that he is an effective president, Sarney will probably be instrumental in the election next November of moderate candidates to the Congress that will also function as the constitutional assembly. He will probably also exercise his considerable influence behind the scenes in setting the agenda for constitutional debates over a parliamentary as against a presidential system, and a federal as against a centralized government. [redacted]

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The Downside Risk

Despite Sarney's early successes and his recently demonstrated decisiveness, we cannot discount the possibility that he may suffer serious economic and political reverses in the coming year. Increased pressure from special interest groups or more intense labor agitation, for example, could cause Sarney to hesitate in trimming the bloated public sector and keeping money expansion in check. This would lead to a spurt in inflation, in our view, which would erode public confidence in the administration and foster social unrest. Likewise, unforeseen adverse developments in the world economy such as a substantial increase in protectionist measures, slumping commodity prices, or weakness in the international banking system would make it difficult for the government to continue sustaining economic expansion with the same effects. [redacted]

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Under such conditions, we believe that Sarney would come under heavy pressure from both the political left and right to strike out in new policy directions. The PMDB leadership, fearful of losing seats to the left in the congressional elections, would press him to move to more populist economic policies, including the

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adoption of radical and confrontational debt measures. Alternatively, conservative business and political groups would push him to fall back on the now discredited authoritarian tradition of the military presidents to decree tougher and less popular policies, a course that would cause his centrist support to evanesce. In our view, Sarney would probably attempt to strike a middle course: he would take a confrontational stance on the foreign debt and on trade and foreign investment policies to defend his left flank while maintaining the stabilization measures to control inflation in order to keep conservative and centrist backers. []

We believe resurgent inflation, a renewed recession, and a decline in Sarney's prestige would significantly affect the conduct of the constituent assembly. It is possible that delegates would shorten Sarney's term and hold a presidential election in mid-1987. More likely is the possibility that leftist and conservative forces would engage in bitter infighting leading to a deadlock over the future of political reforms. With an evaporating political base and eroding public prestige, Sarney would have great difficulty breaking such a deadlock. []

Implications for the United States

Attaching a fairly low probability to such a souring chain of events and anticipating that President Sarney will in fact firm his political and economic footing, we believe he will strive to maintain generally harmonious relations with the United States. Continued bilateral frictions on trade and investment issues are unavoidable given Brazil's growing competition with the United States in world markets and the persisting "statist" aspects of its economy. According to the US Embassy, Brasilia is grateful for President Reagan's rejection of Congressional pressures to impose major import barriers against textiles and footwear, but is wary of prospective US steps to limit imports of alcohol and other key Brazilian products. []

Brazil's trade surplus with the United States will probably remain large, and, therefore, troublesome to Washington. Brasilia's gradual trade liberalization over the past year has provided increased opportunities for US exporters, but current import restrictions

will probably not be quickly dismantled because of perceived vulnerability to foreign payments problems. For example, we believe nationalism and pressures from vested interest groups will make Brazilian concessions on computer industry restrictions difficult and laborious. Although Brazil's continuing unwillingness to seek an IMF program will also continue to be a source of friction with Washington, we believe Sarney will maintain moderate foreign debt policies and attempt to remain in good standing with the international financial community. []

We believe a politically and economically secure Sarney administration would generally be sympathetic to US concerns on noneconomic issues. We believe Sarney would be more sympathetic to US positions on arms sales. [] and narcotics.

Also, Sarney will continue to share US concerns about Soviet and Cuban adventurism in the region. Bilateral strains will persist, however, over the weapons potential in Brazil's nuclear development program. []

If President Sarney's position slips because of a deteriorating economy and growing political opposition, as posited in the downside risks scenario, he would be more inclined toward policy positions inimical to US interests. This would be especially true if economic problems are perceived by Brazilians as traceable to the United States, such as renewed foreign exchange problems stemming from a major resurgence of US interest rates or a spate of protectionist legislation in Washington. [] Brasilia already may have contingency plans for unilaterally limiting debt servicing payments along the lines traced by Peru. The general deterioration of bilateral relations that would probably follow would adversely affect Brazil's current positions on arms sales to countries such as Libya, the control of narcotics in the Amazon, and cooperation on nuclear policy. []

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Foreign Policy Under the Civilians

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To date, foreign policy under the Sarney administration has been characterized by the same hallmarks that came to distinguish it under the military government; it has been pragmatic, noninterventionist, low-key, and aimed above all at securing economic advantage for Brazil. While the Foreign Ministry continues its Third World orientation, Sarney himself is more attuned to preserving good ties to the West, notwithstanding his nationalistic public stance on foreign debt. []

On the basis of US Embassy reporting, however, we believe the thrust in foreign policy will begin to shift slightly. For example, administration officials publicly emphasize Brazil's commitment to fostering democracy and improved multilateral and bilateral relations among Latin American states. The most significant action in this regard was the meeting in December 1985, the first since 1961, between the Brazilian and Argentine Presidents. The two countries issued a joint declaration outlining areas for economic and political cooperation as well as an agreement on nuclear cooperation. Brazil's increased interest in hemispheric matters, however, is unlikely to portend major involvement in Central America. Although Brazil has joined the Contadora support group, we believe that this is an issue on which Brasilia intends to keep a low profile, mainly to protect its economic ties throughout the region. []

The transition from military to civilian rule has brought a slight thaw in relations with the Soviet Bloc. The friendlier tone of relations with the Soviets is best illustrated by Foreign Minister Setubal's visit to Moscow last December, the first since 1961. Although the Foreign Minister was cordial, Moscow did not break any major ground in expanding bilateral links, manifest by the absence of ceremonies announcing major new accords. Instead, we concur with US Embassy reports that the trip was more symbolic than substantive, reflecting Brasilia's suspiciousness toward Soviet motives in South America. []

The Sarney administration has been much cooler to Cuba than to the USSR. []
[] *Sarney is particularly suspicious of*

Cuban motives and is on guard against any expansion of Cuban activities in Brazil and neighboring states. Sarney has delayed reestablishing diplomatic relations with Havana, commercial ties are minimal, []

[] *The US Embassy reports, however, that Sarney intends to restore ties to Castro sometime prior to the November elections to curry favor with the leftist wing of the PMDB. In our view, however, he will probably restrict the size of the Cuban mission and have its activities monitored closely.* []

The Sarney administration responded warmly, however, to China's efforts to intensify bilateral ties. The US Embassy reports that Brasilia apparently has concluded it can have bilateral trade and technological programs without fearing Chinese intervention in domestic affairs or negative reaction from its most important trading partner, the United States. In late October and early November, the Chinese Prime Minister paid a visit to Brazil that was followed closely by Brazil's domestic press. During the visit, Brasilia and Beijing established a consultative commission, signed new cultural and educational cooperation agreements, exchanged military attaches, and laid the groundwork for future technological and scientific accords. []

In our view, the Sarney administration will continue to expand ties where it believes the country can derive economic advantages, largely through increased trade, especially arms sales. In this regard, we believe Brasilia will continue cultivating relations with the Middle Eastern countries; in the wake of the US attacks on Libya, however, the Sarney administration is likely to adopt a low-key approach in its Libyan policy. Fearful of offending the United States, it is unlikely to engage in arms deals or undertake any other high-profile policy initiatives with Tripoli. []

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Moreover, such a deterioration would present the Soviet Union and Cuba with new opportunities to court Brasilia. [] both already have been increasing contacts with—and support for—leftist groups, including the PCB and the more powerful Workers Party. By stepping up their financial assistance to these parties, the Soviets and the Cubans would be able to augment their influence in Brazil's labor, and increase their access to important political and, perhaps, governmental circles.

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